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BEFORE THE ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE APPLICATION OF H2O, INC. FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PROPERTY AND FOR AN INCREASE IN ITS WATER RATES AND CHARGES FOR UTILITY SERVICES.	DOCKET NO: W-02234A-07-0557

Arizona Corporation Commission
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H2O, INC.'S

INITIAL POST-HEARING BRIEF

June 15, 2009

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I. INTRODUCTION.

A. Overview of H2O, Inc. and its Rate Application

H2O, Inc. ("H2O" or "the Company") is an Arizona corporation engaged in the provision of water utility service to customers located in Pinal County, Arizona. During the test year ending December 31, 2006, the Company had an average of approximately 5,843 customers, mostly residential. Direct Testimony of Thomas Bourassa at Schedule H-2. H2O is presently providing service under rates and charges authorized by the Arizona Corporation Commission ("Commission") in Decision Nos. 58641 (May 27, 1994) and 63259 (December 14, 2000). Application at 1.

In the instant application, H2O is seeking a revenue requirement of $3,244,489 [which is $135,153 *less* than currently authorized], on a proposed fair value rate base ("FVRB") equal to the Company's original cost rate base ("OCRB") of $1,995,695. Rebuttal Testimony of Thomas Bourassa ("Bourassa RB") at 3. This proposal represents a rate *decrease* of (-3.97%). Staff is proposing a revenue requirement of $3,218,705 [which is $159,937 less than currently authorized] on a proposed FVRB of negative $(500,901). This proposal represents a rate decrease of (-4.73%). H2O and Staff agree on plant-in-service of $12,996,414 and accumulated depreciation of $1,497,949.

The Company's proposed decrease will produce an 11.46% return on equity.[1] Staff is proposing a 10% operating margin. H2O has made appropriate adjustments to actual test year result and balances to obtain a normal or more realistic relationship between revenues, expenses and rate base during the period in which new rates will be in effect. *See* A.A.C. R14-2-103(A)(3) (definitions of "test year" and "pro forma adjustments"). H2O's proposed adjusted test-year level operating expenses is equal to $3,067,520, and

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[1] Staff has not provided any evidence to rebut Mr. Bourassa's testimony concerning cost of capital. H2O contends that if its own rate base adjustments are adopted, an 11.46% percent return on equity is just and reasonable.

while the Company has accepted Staff's proposed adjustments to revenue and expenses, there remain differences in the levels of depreciation expense, property taxes and income taxes, which are primarily the result of the difference between Staff and the Company on the proper regulatory treatment of unexpended hook-up fees.

The primary issues in dispute focus on H2O and Staff's disagreement over: (i) the inclusion of unexpended hook-up fees ("HUFs") in rate base as contributions-in-aid of construction ("CIAC") for plant not yet built, and unexpended developer advances as advances-in-aid of construction ("AIAC"); (ii) the elimination of the Company's current Off-Site Capacity Reservation Charge Tariff; and (iii) rate design regarding the percentage of annual revenue to be derived from monthly minimum charges versus the commodity charge component of a customer's bill.

B. <u>Procedural History</u>

H2O's application for the determination of the current fair value of its utility plant and property, and for changes to its rates and charges for utility service, was filed on October 1, 2007. On May 13, 2008, the Company filed an amended application. On July 24, 2008, Staff filed a letter in the Commission's docket stating that the Company's application met the sufficiency requirements set forth in A.A.C. R14-2-103, and classifying the Company as a Class B water utility. By procedural order dated July 30, 2008, a hearing was scheduled for March 9, 2009. The Company caused a notice of the rate application to be published. Notice of Publication was filed on October 14, 2008. The evidentiary hearing was later rescheduled to May 4, 2009, and was conducted on that date. At the conclusion of the hearing, the parties were directed to file this Initial Post Hearing Brief. H2O incorporates all the Company's previously submitted testimony, proposed adjustments and schedules, and the testimony of Thomas Bourassa provided during the May 4, 2009 hearing in this matter.

II. RATE BASE ISSUE IN DISPUTE

The parties' respective rate bases following the hearing are as follows:

	OCRB	FVRB
Staff	$(500,901)	$(500,901)
Company	$1,995,695	$1,996,695

H2O and Staff agree that the plant-in-service is $12,996,414, and accumulated depreciation is $1,497,949. The Company has accepted Staff's adjustments to plant-in-service and accumulated depreciation. Bourassa RB at 11-12. Staff has accepted the Company's proposed tax rate of 38.6% for deferred income tax computations. Staff Summary at 1.[2] The lone rate base issue in dispute involves Staff's proposed reductions to H2O's rate base with the inclusion of unexpended AIAC, unexpended HUFs (CIAC) and currently funded construction work-in-progress ("CWIP") totaling $2,859,339.

A. Adoption of Staff's Proposal Would Result in a "Mismatch" Between the Deductions and the Company's Rate Base.

A mismatch occurs when CIAC and AIAC is applied to a utility's rate base (producing a negative adjustment) when there is no corresponding plant-in-service to "match" the adjustment. Bourassa RB at 7, Rejoinder Testimony of Thomas Bourassa ("Bourassa RJD") at 4, Hearing Transcript ("TR") at 27. H2O has approximately $2.7 million in unexpended funds. As Company witness Thomas Bourassa testified, because these *unexpended* funds are for future plant necessary for future customers, there is no corresponding treatment as plant-in-service to increase rate base, and a deduction of CIAC would create a mismatch. Bourassa RB at 4; TR at 27. This is consistent with the Commission's rule on the treatment of CIAC. *Id.* These unexpended funds are being held by the Company, collected pursuant to its Commission approved CRC Tariff and

[2] There is a difference in the deferred income tax amounts which is primarily due to the differences in the rate base treatment of unexpended HUF's.

applicable water main extension agreements, for infrastructure that will be needed to serve growth. Therefore, it is neither plant-in-service nor CIAC includable in rate base at this time.

Had the Company actually built plant with the unexpended funds, and the Commission determined that such plant was either excess capacity or not used and useful, then the value of that plant would have been removed from rate base. Furthermore, the corresponding CIAC associated with the plant would have been removed from the rate base analysis as well. Staff agreed that this is the rate-making principle to apply when calculating rate base. TR at 133. Staff further agreed that the underlying reason there is a deduction of CIAC from rate base in Form Schedule B-1 (A.A.C. R14-2-103, Appendix B) is because there is a **logical connection between CIAC and plant-in-service**. TR at 117.

The Company is not requesting that the unexpended HUFs, which will be treated as CIAC in rate base once the corresponding plant is built, be included in its rate base as plant-in-service. Nonetheless, this presents a situation that is not distinct from a scenario where the plant is already built (with CIAC), but removed from rate base due to some determination of imprudency; in both cases, the Commission should not recognize the plant-in-service, or the unexpended funds, when determining rate base. Likewise, the corresponding CIAC should not be applied to rate base in both instances. Any deviation from this ratemaking principle would result in a mismatch, which is why Staff's treatment of the unexpended funds as CIAC, and subsequent application of that value against the Company's rate base to produce a negative adjustment, is misguided. Adopting Staff's proposal would essentially penalize H2O for not building infrastructure that the Company prudently determined would be excess capacity due to the slow down in housing development. It would also penalize the Company for not seeking to include the unexpended funds in rate base. By contrast, the Company's proposal is consistent with the Commission's rule on the regulatory treatment of CIAC and the long-standing application of the rule. TR at 27.

Staff's proposal has other negative consequences as well. For instance, Staff's amortization of depreciation expense that results from treating the unexpended HUFs as CIAC reduces positive cash flow to the Company. By increasing H2O's CIAC from approximately \$6.6 million to \$9.3 million (the inclusion of unexpended funds), amortization expense increases from approximately \$489,000 to \$685,000, resulting in a reduction of cash flow of approximately \$195,000. TR at 126-129. Staff agreed that this annual cash flow represents funds that that Company could use to reinvest in plant. TR at 130.

B. <u>The Reasons Set Forth in Staff's Pre-Filed Testimony In Support of Its Rate Base Adjustments Are Not Supported By the Record.</u>

In his pre-filed testimony, Staff witness Brendan Aladi argued that it is proper rate making to include H2O's unexpended HUFs and CIAC funded CWIP[3] in rate base because: (1) the Company has use of these funds, (2) it removes excess earnings potential, and (3) it preserves the ratemaking balance. Direct Testimony of Brendan Aladi ("Aladi DT") at 9, Surrebuttal Testimony of Brendan Aladi ("Aladi SB") at 5. These adjustments, Mr. Aladi argues, constitute traditional ratemaking. TR at 92. However, during cross-examination on these specific issues, Mr. Aladi conceded that none of them really apply when considering the facts of this case.

First, Mr. Aladi agreed that the Company does not have 'use' of the unexpended HUF funds, and acknowledged that they are restricted for the cost of infrastructure to serve developments on an individual, project-specific basis. TR at 108-109. Staff's assumption that the plant is already built must come with it the corresponding treatment of

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[3] The Company is not requesting that CWIP be included in its rate base.

CIAC funds as having already been spent. TR at 123. This would essentially free up the cash for the Company to use. However, H2O has no more 'use' of these funds than the money it collects for taxes, which are then paid to the appropriate taxing authority. As set forth in the Company's 2008 Accounting Report on HUFs, the funds are earmarked for specific projects. Second, Mr. Aladi conceded that when the funds are actually spent, there will be no excess earnings because the corresponding plant will be constructed using zero-cost capital. TR at 120-121; *see also* Bourassa RJD at 4-5. The Company does not earn a return on and of CIAC-funded plant. Third, as already demonstrated in Section II.A, *infra*, Staff's proposal actually results in a ratemaking *imbalance* by reducing rate base for CIAC without corresponding plant-in-service to account for such an adjustment.

C. A.A.C. R14-2-103 is a Rule, Not a Commission Policy, And It Should Be Applied To Fit the Specific Facts of This Rate Case.

Having conceded that the reasons provided in his pre-filed testimony to support Staff's proposal do not comport with the fact of this case, Mr. Aladi testified that the Company's use of the unexpended funds was not really the basis for proposed deductions to rate base, but rather that "traditional ratemaking practice" required it. TR at 117. Mr. Aladi testified that Commission rule A.A.C. R14-2-103 requires Staff, as a matter of policy, to recommend the application of H2O's unexpended funds to rate base as CIAC. TR 147-148. When questioned by Staff counsel about Staff Exhibit 5 [Appendix B-Rate Base Schedules, Schedule B-1], Mr. Aladi pointed out that the form schedule contains certain *standard* deductions to rate base, including AIAC and CIAC. TR at 144. However, these are merely *standard* deductions subject to a number of adjustments in the context of a rate proceeding.

A.A.C. R14-2-103 is a comprehensive rule that contains formats for numerous schedules (Schedules A-1 through H-5). TR at 146. This rule sets forth a *framework* for processing rate applications. TR at 147. During cross examination, Mr. Aladi conceded that A.A.C. R14-2-103 does not address the larger rate-making concept of 'matching' particular plant and timeframes to the corresponding CIAC, nor do the form schedules in Appendix B. TR at 145. The rule makes no distinction between CIAC that has been used to build plant, versus unexpended CIAC, and does not provide any further explanation of the treatment of CIAC except to allow for pro forma adjustments. TR at 147. "Pro forma adjustments" is defined in the rule as "Adjustments to actual test year results and balances to obtain a normal or more realistic relationship between revenues, expenses and rate base." A.A.C. R14-2-103(A)(3)(h). Mr. Aladi did concede that the number used for CIAC to deduct from rate base, which is found on line 5 to Form Schedule B-1, can be adjusted by a separate schedule. *Id.* Accordingly, the Company's pro forma adjustments were proposed to obtain a more realistic relationship between revenues, expenses and rate base.

Staff's reliance on A.A.C. R14-2-103 in this proceeding as Commission "policy" is an over-simplification of the rule, and is being utilized as a 'one-size fits all' application to a Company where traditional ratemaking results in the inequities raised by H2O in this proceeding. Staff's strict interpretation of Form Schedule B-1, and its non-recognition of certain adjustments that can and should be made, result in a negative rate base and reduced cash flow for H2O. Such a result will harm the long-term viability of the Company, which is already facing challenges in improving its capital structure. Upon questioning during the hearing, Mr. Aladi was unable to cite to any previous Commission decision where A.A.C. R14-2-103 was applied in a manner proposed in this proceeding. There are two relatively recent Commission decisions that address this issue. However, these two cases can be distinguished from the instant case on several grounds.

In Decision No. 70011 (November 27, 2007) and Decision No. 70360 (May 27, 2008), the Commission applied customer advances (CIAC) to rate base for UNS Gas Inc. and UNS Electric, Inc., respectively – even though corresponding plant had not yet been placed into service, and was not included in rate base. Decision No. 70011 at 8. However, the fact-specific scenarios in those two proceedings were quite different:

- In both cases, the utilities were requesting the inclusion of CWIP in rate base. H2O is not requesting any CWIP in rate base.

- In both cases, the CWIP and/or post test-year plant at issue represented a small fraction of total rate base (3% and 6% respectively). In contrast, the rate base difference at issue between the Company and Staff is approximately 125%.

- In both cases, the utilities were large, well capitalized investor-owned companies with access to credit and debt markets to construct facilities needed to meet growth. On the other hand, H2O relies on developer contributions to meet growth without imposing higher costs on current ratepayers. In the two former cases, ratepayers received a rate increase. In the instant case, ratepayers are receiving a rate decrease.

- In both cases, the utilities were able to choose their test year. As part of its reasoning to deduct CIAC from rate base, the Commission stated that "regulated utility companies control the timing of their rate case filings and should not be heard to complain when their chosen test periods do not coincide with the completion of plant that may be considered used and useful and therefore properly included in rate base." *Id.* at 9. In contrast, H2O was ordered to file a rate case using a test year ending December 31, 2006 or later. Decision No. 69413.

In the UNS Gas, Inc. decision, the Commission recognized that there are instances – especially when dealing with water companies – where a deviation from the traditional ratemaking principles is necessary. "Although the Commission has allowed post-test-year plant in several prior cases involving water companies, it appears that the issue was developed on the record in those proceedings in a manner that afforded assurance that a mismatch of revenues did not occur." Decision No. 70011 at 8.

Likewise, H2O contends that the evidentiary record establishes that a deduction of unexpended CIAC and AIAC from the Company's rate base (which is slightly different than the issues addressed in the UNS Gas and UNS Electric rate proceedings) will create such a mismatch, and result in a negative impact to the short and long-term viability of the Company.[4] Unlike UNS Gas or UNS Electric, the Company did not get to choose its test year, nor does it have access to the capital or debt these companies have. Furthermore, the proposed rate base deduction is not a mere fraction of the Company's overall positive rate base; Staff's proposal produces a *negative* rate base of just over $500,000. Clearly, Decision Nos. 70011 and 70360 should have little, if any, effect as precedent for Staff's utilization of A.A.C. R14-2-103 as Commission "policy" in this proceeding.

When viewed in its totality, Staff's rate base proposal is punitive to H2O. The Commission should be cautious in adopting a proposal that reduces much needed cash flow that can be reinvested in the Company to improve its capital structure without a third-party investor. The establishment of an artificial negative rate base, without any corresponding policy reason for doing so, will make it even more difficult to attract potential buyers that are well capitalized, and who could move the Company towards a more balanced capital structure. Finally, it would create a disincentive for utilities like H2O to refrain from building excess plant with developer advanced funds in the absence of growth, and then requesting that such plant be included in rate base so that when it is removed (as excess capacity or not used and useful), the corresponding CIAC is also removed from the rate base adjustment. In light of these policy considerations and the evidentiary record, H2O requests that the Commission reject Staff's proposal to remove unexpended CIAC and AIAC from the Company's rate base in this proceeding.

III. RATE DESIGN ISSUES.

A. Elimination of the Company's CRC Tariff Will Severely Limit Its Ability to Construct Plant Needed for Future Growth.

Because H2O has limited earnings and access to capital, the HUFs have assisted in

[4] Staff concedes it would be extremely difficult for the Company to get a third-party investor to issue private equity based on its balance sheet and income statement. TR at 83-84.

constructing plant necessary to serve growth. Bourassa RJD at 7; TR at 23. This method of funding plant for future growth has kept rates in check by bringing in zero-cost capital such as CIAC and advances. TR at 24. "The purpose of the capacity charges payable to H2O, Inc. ("Company") pursuant to this tariff is to equitably apportion the cost of constructing additional facilities to provide water production, storage, pressure and fire flow ***among all new service connections***." *See* Exhibit A-6.

Clearly, the Commission was concerned about the equitable apportionment of costs for new facilities between existing and future customers when it approved the CRC Tariff. Under this methodology of funding future plant, growth pays for growth – and existing ratepayers enjoy the benefit of zero-cost capital. Indeed, H2O's customer will enjoy a rate *decrease* as a result of this rate proceeding. H2O is unaware of any shift in Commission policy that would support (much less mandate) the elimination of the Company's CRC Tariff.[5] Furthermore, the Company does not intend to fund all future offsite facilities with HUF funds over the long-term, because the existing fee will not cover the costs of all the backbone facilities needed to serve growth. TR at 55. Therefore, while Mr. Bourassa does concede that H2O should not rely too heavily on contributed plant in the form of CIAC, the payments of HUFs by developers nevertheless serve as an important tool in the ability of the Company to meet growth demands. *Id.*

According to Staff, HUFs contribute significantly to the Company having a negative rate base. Aladi SB at 6. But the negative rate base is an artificial result created by Staff's proposed mismatch. In addition to the negative impact CIAC has on H2O's capital structure, Mr. Aladi testified that Staff's recommendation to eliminate the CRC Tariff was also based on the fact that it did not have information requested from the

[5] The Commission has opened a generic docket on the use of hook-up fees for electric and natural gas utilities. Docket Nos. E00000K-07-0052 and G0000E-07-0052. The Company is unaware that hook-up fees for water and wastewater utilities is the subject of a current generic Commission docket.

Company concerning the CRC Tariff.[6] TR at 93. Staff now has that information, and should use it in formulating its recommendations in this specific case. Mr. Aladi conceded that the Commission has not established criteria for the elimination of HUFs for water companies. TR at 94-95. Although Mr. Aladi agreed with ALJ Nodes' description of the Commission's broad concerns about the long-term viability of utilities whose capital structures are heavily weighted towards contributed capital (via HUFs), he also conceded on cross-examination that Staff's general approach to address this concern is to review such utilities on the basis of an operating margin. TR at 103.

Conceivably, if the Commission ordered the elimination of H2O's CRC Tariff, it could order the Company to refund unspent contributions. TR at 98. However, such a result would be devastating to the Company, and would be contrary to existing water main extension agreements approved by the Commission. As previously addressed herein, the $2.7 million in unexpended CIAC is already earmarked for individual projects. By contrast, the $833,367 refunded in the Black Mountain Sewer Company ("BMSC") rate proceeding alluded to by ALJ Nodes was the result of a Staff recommendation premised on its conclusion that BMSC's parent had access to sufficient capital, and that the Company had misspent some of the funds. *See* Decision No. 69164 (December 5, 2006) at 28. Furthermore, BMSC accepted Staff's recommendation to refund the hook-up fees because the company <u>was</u> adequately capitalized to make necessary investments for infrastructure, including improvements to resolve odor problems. *Id.* at 29. H2O does not have the advantages that a corporate parent is likely to bring, and does not have access to the capital markets as it is not publicly traded. Again, the specific facts contained in the BMSC matter differentiate it from the instant proceeding.

Mr. Aladi recognized the financial challenges facing H2O at this time. He agreed

[6] The Company filed its Annual Report for 2008 on CRC collections and disbursements on April 21, 2009. The report provides information responsive to Staff's request for information.

that it will be difficult for the Company to find a third-party investor. TR at 83-84. He also somewhat acknowledges that securing a loan would also be difficult, depending on several factors. *Id.* Coupled with an artificially low rate base, eliminating the CRC Tariff is very likely to exacerbate the Company's financial condition. The practical effect of eliminating this source of funding plant for future customers will be to force the Company to secure equity and/or debt at a cost that will have an impact to its ratepayers.

B. <u>Staff's Proposed Rate Design Provides Less Revenue Stability for the Company.</u>

Both the Company and Staff propose similar rate designs. Monthly minimums are scaled on the flows of a 5/8 inch meter. The 5/8 inch and ¾ inch residential meters have an inverted three tier rate design. The 5/8 inch and ¾ inch commercial and irrigation meters, as well as any one inch or larger meter, have an inverted two tier design. Bourassa RB at 14. However, there is a disagreement between the parties on the appropriate distribution between fixed monthly minimums and the commodity charge for the collection of the revenue requirement. Staff's proposed rate design provides approximately 35 percent of revenue from monthly minimum charges, while the Company's provides approximately 44 percent. *Id.* The Company's proposal does not result in a significant shift from the existing rate design, which recovers approximately 45 percent of revenue from monthly minimum charges under current rates. Bourassa RB at 15. Deviation from the current distribution is likely to result in revenue instability. TR at 223.

Staff's proposal is based on a conservation-oriented approach. Aladi DT at 21. But so is the Company's proposal, with an inverted three-tiered rate design. TR at 38. However, Staff has not provided sufficient evidence in the record that its proposal will achieve the price signals necessary to incent water conservation among H2O's customers. In contrast, the Company's rate design proposal balances the need for H2O to have revenue stability, while at the same time communicating a conservation message to its customers. TR at 36-37. The Company recognizes that the Commission has become increasingly aggressive in its water conservation goals. But given all the financial challenges facing H2O at this time, a reduction in revenue stability will likely have a disproportionate impact on the Company than on larger, well capitalized water utilities.

IV. CONCLUSION

H2O recognizes that it has a less than ideal capital structure. However, the road towards financial health should not include an artificial reduction to its rate base, the elimination of its CRC Tariff and a rate design that exposes the Company to an increased level of revenue instability. The national economic turndown has tightened both private equity and credit markets, so the most likely source of capital for H2O remains the funds available to the Company after operation expenses are made. Furthermore, the lack of available equity and access to debt means that growth should continue to pay for growth while the Company works to improve its capital structure. Elimination of the CRC Tariff, and certainly any requirement to refund unexpended funds, will require existing customers to bear the financial burden of growth when the Company is required to build facilities to serve properties pursuant to Commission-approved water main extension agreements.

If the Commission adopts all of the Company's recommendations, ratepayers will still receive a -3.97% rate reduction as a result of this proceeding. H2O respectfully asserts that keeping it financially viable in the manner proposed by the Company (based on ratemaking principles that are consistent with Commission policy) will serve the public interest.

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RESPECTFULLY SUBMITTED this 15th day of June, 2009.

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